July 7, 1993

Long-run Ranges
Donald L. Kohn

As background for consideration of the semi-annual report to Congress, the bluebook on page 8 shows simulation results for three longer-term strategies for monetary policy. The point here is not to home in on specific estimates for particular outcomes in specific years, but rather to illustrate, very broadly, the possible paths the economy and prices could trace out over the medium term in response to alternative emphases in the implementation of monetary policy. The three strategies include a baseline case--strategy one--that extends the greenbook forecast and gives weight to reducing both unemployment and inflation over coming years. Under strategy two, the FOMC is assumed to place somewhat greater emphasis on achieving price stability--being willing to give up some progress in reducing unemployment for a time. Strategy three shows results for policy that tilts toward reducing unemployment more rapidly, risking no further progress or even some retrogression on the inflation front. The different strategies cannot be matched up neatly with alternative annual ranges for money growth, but the results illustrate underlying economic relationships the FOMC may want to have mind as it thinks about its medium-term approach to policy and how that approach is best described to the public.

The results associated with different strategies are greatly influenced by the starting point, and one important aspect of the economy at present is its relative proximity to reasonable approximations of both full employment and price stability. Consequently, according to the model, moderate changes in the funds rate one way or the other can get you to the vicinity of one or the other goal over the next few years, and the middle course of the baseline case is able to achieve only modest reductions in inflation and unemployment simultaneously. The consequences of the starting point show up most clearly in the easier strategy. A one percentage point reduction in the funds rate may need to begin being reversed fairly quickly to limit overheating, even with the moderately restrictive underlying thrust to fiscal policy assumed under all the strategies.

Even in the baseline case, short-term rates have to rise before the end of next year, reflecting the underlying assumption that short-term real rates are now at unsustainably low levels. However, that rise, which continues through 1998, is not reflected in real long-term rates. Long-term rates are seen as still at fairly <u>high</u> levels, given the assumed fiscal policy. A prolonged rise in real short-term rates without a sympathetic response in real long-term rates would be unusual--but so too would be the extended period of fiscal restraint used in the simulations.

As the economy moves up, inflation gains come a little harder than they did in 1991 and 1992. The simulations incorporate a fairly standard sacrifice ratio to calibrate medium-term inflation/output trade offs, but it is higher than that experienced when unemployment was both high and rising. As a consequence, even with no allowance for the effects of possible taxes or added regulation on costs and prices, significant gains on price stability under the tighter alternative require delaying appreciable reductions in the unemployment rate until late in the simulation period.

Reflecting both a damped sensitivity of M2 to short-term market rates and lags in the effect of changes in interest rates on output, the M2 paths under the three policy scenarios are very little different in the first few years. In addition, overall demand for M2 assets is assumed to remain quite damped for a time, and the forces holding back M2 growth to be abating slowly.

This analysis is reflected in our projections for growth in money and credit in 1993 and 1994, which are shown in the table on page 11 of the bluebook. We expect continued sizable increases in the velocities of M2 and M3, even with the relatively small movements in interest rates underlying the Greenbook forecast. The reasons for this are familiar: Demands for bank credit are expected to be subdued as long-term securities markets remain attractive alternatives for borrowers seeking to strengthen balance sheets; although banks seem to be becoming more willing lenders, the changes are incremental, their securities portfolios are swollen, and we do not expect them to bid aggressively for funds; finally, with the yield curve remaining fairly steep for some time and mutual fund sales spreading to more depository offices, shifts from M2 balances should continue--in effect financing business and household balance sheet strengthening.

We do anticipate that these forces will ebb gradually. Financial conditions for borrowers and lenders are improving, reducing the impetus to balance sheet restructuring; the yield curve, while steep, is flattening a little in the forecast horizon; and over time asset portfolios of money holders will become adjusted to the yield curve and easier access to mutual funds.

Putting all this together, along with some adjustments for special factors, we project M2 growth of one percent this year and 2 percent in 1994 to accompany Greenbook GDP projections. M3 is seen as unchanged this year and increasing only one percent next year. The projections for 1993 are a little below those given in February, despite the fact that both aggregates are about where they were expected to be at that time. Some of this downward revision reflects the slower growth of nominal GDP now projected by the staff for the year. Another portion of the revision owes to the anticipated depressing effect of some special factors, including a lower level of mortgage prepayments by the end of the year. The debt of nonfinancial sectors is projected to increase 5 percent in both years, in line with the growth in nominal GDP and a little below the February projection; within the debt total, a tapering off of Federal debt growth offsets some pickup in private borrowing.

There are risks on both sides of these forecasts. As noted, we do have some moderation in the forces pushing up velocities. Shifts of M2 demand relative to the old standard models diminish, though they are still occurring. Partly as a consequence, the rate of velocity increase slows slightly in 1993 relative to 1992 and moderates further in 1994 for both M2 and M3. On the other hand, we do not have them abating as rapidly as they seemed to be in the second quarter. We have discounted the sudden pick up in bank credit and money growth as being partly attributable to special factors, as well as to the noise inherent in any economic series.

You might want to adjust our projections to the appreciably stronger nominal GDP you are projecting relative to the staff. We wouldn't expect GDP along your steeper path to have much effect on money growth this year--perhaps a quarter point on M2. But, with your GDP and assuming the staff interest rates for next year, we would add maybe 3/4 of a percentage point or even more to our projection of M2 growth, with some smaller spillover into M3 and an equal or larger increment to debt growth to finance the additional spending.

Thus, even with your GDP, we believe the odds on hitting the current money ranges in 1993 are fairly small, and we would have debt growth in the lower portion of its current range. Retaining the current money ranges for this year thus would seem to require either sizable easing in reserve conditions fairly soon, or a declaration that we didn't intend to hit the money ranges absent unexpected developments in velocity. An appreciable weakening in the upward trend in velocity would indeed be a surprise, given the persistence and strength of forces that seem to be damping M2 demand. In fact, judgmental velocity predictions have not been that far off over the past year or so, though a one percentage point miss would not be large even by these standards.

Reducing the ranges would seem to give a more accurate picture of the growth in money likely to be associated with the economic outcomes expected by the Committee. Persistently falling below the ranges may erode public confidence in the Fed's ability to project economic and financial variables and can have costs in the political arena as well, though, to be sure, reducing the ranges has also drawn flak. Consequently, on page 14 we presented two lower sets of ranges as alternatives to the existing ranges for 1993. Deep reductions, as in alternative III, come closest to centering the ranges around likely money and credit growth. This alternative allows for even slower growth in money in the second half of the year than the first, and so might be especially desirable if the Committee wanted to stress its determination to contain any emerging inflation pressures. But the

Committee may not want to signal that it would possibly accept financial conditions consistent with the low ends of the Alternative III ranges, which include no M2 growth and a decline in M3. One percent M2 growth and a small drop in M3 in the first half of 1993 have been associated with downward revisions in the Committee's expectations for nominal GDP this year. The Committee may view the lower nominal GDP now predicted as acceptable and even desirable in the context of concerns about price pressures. But at the same time you might want to be on record as being ready to resist any significant further weakening tendencies. Alternative II, by retaining the one percent lower limit to the M2 range and zero for the bottom of the M2 range would seem to send that signal more clearly.

For 1994, the staff has proposed the same three alternatives. As noted, FOMC nominal GDP might be associated with M2 growth of 2-3/4 percent or so. Thus, assuming this nominal GDP was considered a desirable outcome, and that it could be attained with about the staff interest rate outlook, the 2 percent lower end of the alternative I range for M2 looks tenable, though a bit on the high side. The M2 consistent with your forecast would be about centered on a 1 to 5 percent range, as in alternative II. And M3 likely would be in the lower half of the alternative II range, but not at the lower end. Lower ranges in both years might provide a counterweight in terms of public perception to the lack of a downward tilt in the Committee's inflation forecast. Especially if the ranges for 1993 were reduced, adopting higher ranges for 1994 would seem to conflict with the Committee's anti-inflation message. Adopting even lower ranges, as in alternative III, for 1994, however might be seen as underscoring that message. An M2 range of 0 to 4 percent for 1994, as an alternative

III, would be better centered on the staff forecast, as would the ranges for M3 and debt. If that forecast were considered a desirable outcome, this alternative could be attractive. Depending on how it was explained, it could emphasize the magnitude of velocity shifts and the FOMC's desire to re-establish a downward trend to inflation.

Reducing the ranges a full percentage point, as under alternative II, or by even more, as in alternative III, either this year or next, would diverge from the Committee's long time policy of small gradual reductions in the ranges to emphasize progress toward price stability. It may be that, given velocity shifts and complex money-interest rate relationships, the ranges can no longer be adjusted in small, incremental, and reasonably predictable steps to implement or communicate this long-run objective.

July 7, 1993

Short-run policy
Donald L. Kohn

As many of you remarked yesterday, there are no easy answers for monetary policy when faced with a more adverse near-term price/output trade off. With both staff and FOMC revising their forecasts in the direction of more inflation and less growth, it is clear that some shock is thought to have occurred, and to be of more than transient duration. It seems to me that one factor keying your reaction to this development ought to be your judgment as to whether the adverse inflation news results from one-time price level increases or are a part of a more persistent process in which given levels of slack in the economy are now associated with less downward pressure in inflation rates. I have nothing new to add to Mike's presentation in this regard. Presumably the former would require less of a policy response than the latter, especially if your goal was reducing inflation rather than holding a predetermined price level. Still, the dichotomy is not stark, since price level changes--actual or expected --can feed through to inflation expectations and hence to more persistent inflation, though in the absence of fundamental changes in underlying relationships those expectations should eventually fade.

At your last meeting, your concerns apparently were about the possibility of more persistent higher inflation, perhaps operating through expectations. With incoming data presumably alleviating some of the most intense concerns about a near-term ratcheting up of inflation and inflation expectations, the question facing the Committee at this meeting would seem to center more around the symmetry or asymmetry of the directive, rather than immediate policy action. In one sense, of course, this decision may prove to have mainly symbolic import, since tightening--or easing--could be undertaken from either directive, and since an asymmetry does not necessarily imply a policy move. But, the directive, even if not public, could color the tone of the upcoming report and testimony. And, on a more substantive note, it does indicate the kind of response the Committee contemplates to incoming data.

Retention of an asymmetrical directive toward tightening suggests some predilection to react reasonably promptly to adverse price news, with less weight on real-side information, perhaps unless such information indicated an appreciably weaker trajectory for the economy than anticipated. Such a predilection might arise from the view that short-term rates were now at levels likely ultimately to promote higher inflation, that in current circumstances the next policy action probably needed to be toward the tightening side, and further that the System was in danger of "falling behind the curve" in this regard. Evidence in the data that inflation was in fact ticking up would tend to confirm these concerns. Such an uptick, if it persisted, might be considered a threat to the long-run sustainability of the economic expansion.

In terms of the "optics" of asymmetry, retaining such a directive suggests a consistency in outlook and purpose over time, given only one month's better price data since the last meeting and mixed information on the real side. Viewed against the Committee's own projections of little progress in reducing inflation, such a tilt might be seen as a bit of a counterweight in terms of credibility and price stability--at least the Committee had given notice that it would not tolerate persisting higher inflation. And, relative to the real side of the economy, a tilt would seem more comfortable with the Committee's projections of somewhat stronger growth over the next six quarters than with the staff forecast.

A symmetrical directive would not rule out the possibility or even the likelihood that the next move would be to raise rates, but it would suggest that such an increase was not anticipated in the immediate future. A shift in the tilt of the directive after only one meeting would be unusual, but not unprecedented. It would seem to connote that the information received since the last meeting had quieted inflation concerns, so that a prompt response to an outsized increase in a price index was not as important. Such information might be seen as having included, in addition to the price data themselves, data suggesting softer aggregate demand and better prospects for fiscal restraint. These indicators might be read as pointing to fundamentals in terms of resource utilization that were inconsistent with rising price pressures over time. In these circumstances, higher inflation and inflation expectations could be seen as less likely to persist. While some commodity prices have risen, the downward movement of bond yields, and perhaps the simultaneous upward movement of the dollar, do not indicate increases in longer-term inflation concerns.

Finally, Mr. Chairman, as I pointed out in the discussion of long-term ranges, the staff has discounted to an extent the recent strength in money and credit. We see fairly subdued money growth going forward--on the order of 1 percent M2 and 1/4 percent M3 growth over the next three months--as consistent with greenbook GDP under the flat interest rate assumptions of alternative B. As a consequence we have suggested that the last sentence in the directive refer to Committee expectations of modest money growth over the third quarter.